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UNCLAS SECTION 01 OF 02 BELGRADE 000184

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USDOC FOR 4232/ITA/MAC/EUR/OEERIS/SSAVICH

E.O. 12958: N/A
TAGS: ECON EFIN EINV PGOV SR
SUBJECT: Serbia: January Economic Data Highlights Sharp Downturn

SUMMARY

¶1. (SBU) Newly released data from January showed the sharp downturn in the Serbian economy as the financial crisis affected the currency, trade, and production. While layoffs have not yet made headlines in Serbia, the data show that Serbia is not insulated from the global crisis and the government's public messages are increasingly sober about the challenges that the country will face. The full effects of the crisis are yet to come, but the 17% decline in industrial production in January, and the nearly 38% decline in imports, opened what will be a difficult year. The continued fall of the dinar challenges banks, businesses and consumers to forecast their costs. End Summary.

Economic Activity Slows Sharply as 2009 Opens

¶2. (U) Economic data released in the last several days demonstrates the sharp decline in economic activity in Serbia. Industrial production in January 2009 was down 17% from 2008. The Serbian government pointed to the Russia-Ukraine gas crisis as a significant contributor to the decreased economic activity, but clearly the economic crisis is hitting Serbia's real economy. At the same time, inflation in January was 2.3% with an annualized rate of 10.7%. Increases in government-controlled prices, including public transportation, contributed to inflation even as market prices for some food products declined with decreased international demand.

¶3. (U) Serbia's exports in January 2009 fell 24% from January 2008 levels to $480 million. At the same time imports fell by an even larger percentage, 37.5%, to $850 million. The one positive aspect of these declines was the relatively larger fall in imports, which reduced Serbia's trade deficit by almost 50%. Also, Serbia's trade with its Central European Free Trade Agreement (CEFTA) partners remained in surplus thanks to food products exports to the region.

Dinar Fall Continues

¶4. (U) Pressure on the dinar continues despite the $1.9 billion in reserves that the National Bank of Serbia (NBS) has spent since October to manage the decline of the dinar. The pressures of continued inflation driven by reduced state subsidies in energy and public transportation prices, combined with the fall of the dinar, limit the NBS's flexibility to cut domestic interest rates. The NBS maintained the reference interest rate at 16.5%, which increased the cost of borrowing in dinars for businesses and often left cross-border borrowing in euros as the only cost competitive alternative for new borrowing for companies strong enough to qualify for credit. The continued cost-driven pressure to secure credit in euros perpetuates the currency risk to the Serbian economy and makes it more difficult for banks to adequately assess the risk of their loan portfolio.

¶5. (SBU) As the crisis deepens, the dinar nears the psychologically significant barrier of 100 dinars/euro. On March 2 Deputy Prime Minister Djelic told us that at a March 1 meeting of the Democratic Party leadership, the party agreed that the government could not allow the dinar to sink past 100 dinar/euro. Unfortunately, the government has limited tools to influence the exchange rate and the NBS is reaching the limit of the reserves that it can spend managing the decline of the dinar's value. At a February 26 seminar organized by the American Chamber of Commerce (AMCHAM), Bosko Zivkovic, a member of the Prime Minister's economic advisor team, said that the NBS was nearing the limit of reserve spending to manage the dinar's decline and that a new paradigm for foreign exchange stabilization was needed.

Banks and Businesses Buckle Down

¶5. (U) While the Serbian banking system is under pressure and banks are seeing repayment problems grow for debtors across the spectrum of risk, the banking system is not under threat. Bank profits in 2008, even with the clear beginnings of the downturn in the fourth quarter, were strong and capital adequacy ratios remained at 23% in 2008, according to Raiffeissen's Deputy Chairman Zoran Petrovic. Erste and Raiffeissen both announced 2008 results recently and recorded record profits.

¶7. (U) The sharp drop in industrial production and the rapid decline in imports highlight the crisis's effect on business activity in Serbia. Board members from both the Foreign Investors Council (FIC) and the AMCHAM made public statements in the past week that member companies remained committed to Serbia, but that the crisis would reduce or postpone investment plans.

Comment

¶8. (SBU) This week nearly all of the Serbian economic leadership - government, business and academic -- is at the Serbian Economists Association's annual business conference. While the conference is traditionally the most significant economic discussion in the country, with the press referring to it as "Serbia's Davos," this year's discussion has started out with a very sober tone about the challenges to come. Serbia's brightest economic minds will be challenged to come up with a cohesive vision to lead the country through the coming months. The government's options are limited, but as the January economic data demonstrates, there is no more talk that Serbia can isolate itself from the pressures of the global economy. End Comment.

BRUSH